Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Price Cap Performance Review for Local Exchange Carriers Notice of Proposed Rulemaking	CC Docket 94-1

REPLY COMMENTS OF BELL ATLANTIC

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In contrast, eliminating both the sharing mechanism and the lower bound adjustment (as well as the archaic depreciation practices that go along with them) will provide LECs the same incentives as a competitive market to invest in an advanced infrastructure, while imposing on LECs the full downside risk of loss.[18] It also will provide parity of regulatory treatment with competitors such as AT&T and the cable industry[19] -- something that is critical as these competitors increasingly move into one another's core businesses.

Moreover, claims by opponents that sharing cannot be eliminated because the LECs will "overearn" are wrong.[20] In the first place, mechanisms designed to monitor and control earnings for any purpose are holdovers from rate of return regulation that have no place in a price caps scheme.[21] The Commission itself

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[18] See Kahn Aff. at ¶¶ 18-28; Vander Weide Aff. at ¶¶ 16-18.

[19] See Kahn Aff. at ¶ 16; Vander Weide Aff. ¶¶ 21, 23-25; Harris Reply Report at 26.

[20] See, e.g., Comments of AT&T at 30; Comments of Ad Hoc at 24-25.

[21] The purpose behind price caps is to give LECs an incentive to promote efficiency and innovation by allowing them to keep the benefits of their efforts. Penalizing them for being successful and requiring them to forego some or all of the benefits because of their success destroys these incentives. See Vander Weide Aff. at ¶¶ 16-18; Kahn Aff. at ¶ 20.

increasingly compete with one another using the same types of technologies to provide the same types of services.

By the same token, claims by opponents who urge a one-time adjustment to LEC rates also are wrong.[30] In the first place, such a measure would destroy the very incentives that price caps are designed to create; LECs that failed to become more efficient would be rewarded with higher rates, while those that successfully cut costs and improved efficiency would be denied the benefit of their efforts.[31] But in addition, as Dr. Vander Weide shows, a one-time adjustment here based on an economically correct measure of LEC earnings would actually entitle LECs to raise their prices.[32]

Finally, opponents who argue that the earnings target for the LECs should be lowered also are wrong.[33] While it is true that interest rates are somewhat lower than when price caps first took effect, the intervening period also produced a

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[30] See, e.g., Comments of MCI at 28, Comments of AT&T at 30-33.

[31] Vander Weide Aff. at ¶¶ 12-15; see also Bell Atlantic Comments at 12-13.

[32] Vander Weide Aff. at ¶ 46.

[33] See, e.g., Comments of MCI at 30; Comments of AT&T at 31.

More fundamentally, the so-called "studies" that they rely upon are flawed. Both the Commission[43] and some of these same commenters[44] have previously recognized that a total factor productivity study is the correct way to measure productivity. In fact, AT&T has relied in the past on total factor studies performed by the same expert -- Dr. Christensen -- that conducted such a study on behalf of the LECs here.[45] Nonetheless, in an effort to produce their desired result, the commenters here choose to rely instead on indirect measures of LEC productivity that can be manipulated to produce a higher number.

For example, AT&T claims the productivity offset should be increased based on an examination of LEC earnings.[46] But the effect of this would be to return to rate of return regulation through the back door, and to do so erroneously based on a meaningless measure of accounting profits.[47] MCI, on the other

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[43] See AT&T Price Cap Order, 4 FCC Rcd at 2979 (recognizing that "total factor productivity" is the "superior productivity measure").

[44] See, e.g., AT&T Comments at Appendix F, CC Dkt No. 87-313 (filed Oct. 19, 1987).

[45] Id.

[46] AT&T Comments at 22-38 and App. C.

[47] NERA Economic Performance of the LEC Price Cap Plan: Reply Comments, at 33-34 (June 1994) (attached to USTA Reply Comments) ("NERA Reply Study"); Vander Weide Aff. at ¶¶ 12-15.

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AFFIDAVIT OF DR. JAMES H. VANDER WEIDE
IN SUPPORT OF REPLY COMMENTS OF BELL ATLANTIC

June 29, 1994

their parent RBHCs than their earnings for a particular year."[7] Neither of these two statements provide a correct test of the proposition that the RHCs have disinvested in the BOCs in recent years.

11. Comparing cash dividends to earnings for a particular year is an invalid test for the proposition that the RHCs have disinvested in the BOCs. Cash dividends are paid out of cash, not earnings. A more appropriate indication of the BOCs' investment policy is to compare the BOCs' cash dividends to the RHCs to their cash flows from operations. If the BOCs' cash flows from operations exceed the BOCs' cash dividends to the RHCs, then only one conclusion is possible: the RHCs are continuing to aggressively invest in the BOCs. From the publicly available data shown in Schedule 4, I have determined that the BOCs' cash flows from operations have ***exceeded*** their dividends to the RHCs by 42 billion dollars over the period 1991—1993. The proposition that the RHCs have disinvested in the BOCs, therefore, is false. In addition, the Commission should recognize that it is necessary to compare dividends to cash flows over a long time-frame, because investment levels may vary significantly in the short-run.

IV. The Commission should reject efforts to reimpose rate of return regulation.

12. Commenters seek to 1) increase the productivity factor in response to the price cap LECs' earnings in the period 1991—1993; and 2) further reduce the price cap index by an additional 7.5% for the purpose of removing the

[7] Dr. Lee L. Selwyn, et. al., LEC Price Cap Regulation: Fixing the Problems and Fulfilling the Promise, Attachment A, Comments of The Ad Hoc Telecommunications Users Committee, page 68.

price cap LECs' alleged overearnings during the 1991—1993 period. Both are thinly-veiled attempts to reimpose rate of return regulation. Under rate of return regulation, a firm's rates are based on the Commission's judgment of the firm's cost of capital, which becomes its authorized rate of return. If the firm increases its earnings beyond its authorized rate of return as a result of efficiency improvements or the introduction of successful new products, its likely "reward" will be a mandated decrease in its rates to bring its overall rate of return back to the authorized level. The effect of increasing the productivity factor and reducing the price cap index to take away alleged overearnings is the same as the effect of rate of return regulation: rates would be lowered because of productivity improvements and higher earnings during the first three years of the plan.

13. In its NPRM for this Docket, the Commission recognized many problems with rate of return regulation. In particular, the Commission noted that rate of return regulation: 1) "discourages efficient investment;" 2) "encourages cost shifting;" 3) provides "little profit incentive to introduce new and innovative services;" and 4) "requires elaborate regulatory oversight of all the carriers' costs."[8] The recommendations to increase the productivity factor and reduce the price cap index in response to alleged excessive price cap LEC earnings levels during the initial price cap period would produce the same deleterious effects as rate of return regulation.

14. The recommendations to increase the productivity factor and reduce the price cap index are based on the false assumption that the price cap

[8]NPRM at ¶11.

retain the regulatory reliance on arbitrary cost allocation rules; 3) increase the administrative burdens of regulation; 4) reduce the price cap LECs' ability to raise the capital necessary to build an advanced telecommunications infrastructure; and 5) produce an unfair competitive advantage for the IXCs, CAPS, and cable TV companies. In addition, the sharing mechanism and low end adjustment incorrectly rely on the price cap LECs' accounting rates of return rather than their economic rates of return. Because the price cap LECs' accounting rates of return overstate their economic rates of return, the price cap LECs have been artificially forced into the sharing range.

17. Retaining the sharing mechanism while eliminating the low end adjustment would give the price cap LECs no incentive to invest in the telecommunications network or the NII. If the price cap LECs earn rates of return above the cost of capital, they would have to share their earnings with ratepayers. On the other hand, if the price cap LECs earn rates of return below the cost of capital, the deficit would fall entirely on the shareholder. Since the earned rate of return is equally likely to fall above or below the cost of capital, the average, or expected, rate of return under this recommendation would be lower than the cost of capital. No rational investor would invest in telecommunications infrastructure if the average rate of return is expected to be lower than the cost of capital.

18. Lack of symmetry is not the only problem with the recommendation to retain the sharing mechanism and eliminate the low end adjustment. The sharing mechanism itself creates perverse incentives for the price cap LECs. As their earned rate of return approaches the 50 percent sharing threshold, the price cap LECs have significantly diminished incentive to become

telecommunications industry and competing with LECs. For example, Telecommunications, Inc. is a part-owner of Teleport and has announced that it will invest $2 billion over the next several years to install fiber in its network so that it can be the multimedia carrier of choice for its customers.[9]

25. Given the rapid convergence of the interexchange, local exchange, and cable industries, it is essential that the interexchange carriers and the cable TV companies be held to the same regulatory standards as the price cap LECs. If one side were to gain an advantage through the regulatory process, the benefits of competition could be lost. In order for a competitive cable/telecommunications marketplace to develop, the Commission should set the price cap LECs' rates using the same principles and methodologies as it applies to the interexchange and cable TV companies. Regulatory parity requires that the Commission 1) eliminate the sharing and low-end adjustment mechanisms; 2) eliminate depreciation prescription; and 3) reduce the productivity factor to no higher than the amount mandated for cable.[10]

VII. The Commission should reject the recommendation to lower the price cap index to reflect alleged changes in the cost of capital.

26. The recommendation to lower the price cap index to reflect alleged changes in the cost of capital is based on a fundamental misunderstanding

[9] Mark Wrolstad, "TCI to build 'data superhighway'; Fiber-optic network to cost firm $ 2 billion", *The Dallas Morning News*, at 1D (April 13, 1993).

[10] The Commission has preliminarily set the offset at two percent. *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, Further Notice of Rulemaking, MM Docket No. 93-215 at ¶ 320 (rel. March 30, 1994).

of the purpose and implementation of price cap regulation. The Commission's price cap plan is designed to break the link between a company's prices and its costs, including its cost of capital. If the Commission changes the price cap index to reflect alleged changes in the cost of capital, it will reestablish the link between the price cap LECs' prices and their capital costs, thus depriving the price cap LECs of any incentive to reduce their capital costs through actions such as capital/labor mix decisions, debt refinancings, tougher underwriter and bank negotiations, and capital structure decisions.

27. The recommendation to lower the price cap index to reflect alleged changes in the cost of capital also fails to recognize that general changes in the cost of capital are already accounted for by changes in the GNP-PI, and that industry specific changes in capital costs, caused, for example, by differences in input mix, are already accounted for in the productivity offset. The productivity offset incorporates any differences between economy wide and telecommunications industry specific input prices. Thus, the benefits of any reductions in capital market costs that may have occurred during the initial plan period have already been passed through to ratepayers.

28. The AT&T recommendation to lower the price cap index to reflect alleged changes in the cost of capital correctly recognizes that general changes in the cost of capital are already accounted for by changes in the GNP-PI. Their recommendation, however, fails to recognize that industry-specific changes in the cost of capital are already accounted for in the productivity offset.

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The net result starts to look very much like the circumstances which existed under rate of return regulation. Thus, rather than considering adjusting LEC PCIs for changes in capital costs or any other cost component, the Commission should be taking a step in the opposite direction by eliminating the sharing and low-end adjustment mechanism. This would eliminate the last vestige of rate of return regulation in the LEC price cap plan.[58]

While the above discussion may seem like a tangential foray into Economics 101, it is not -- it is the heart of price cap regulation. The Commission cannot have it both ways -- it cannot obtain the benefits of price cap regulation and at the same time adjust prices for selected cost changes (e.g., as was the case under rate of return regulation).[59] Price cap regulation virtually guarantees that consumers of LEC access services will experience price changes that are at least 3.3 percent less than the general level of inflation. Conversely, LECs have no guaranteed return, only the opportunity to increase earnings through efficiency gains. This is a significant difference from rate of return regulation, particularly when the effects of compounding are taken into account.

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[58]Adopting any of the "cost of capital" arguments proposed in this proceeding will only encourage competitors to expend their energies in regulatory forums rather than in the marketplace.

[59]The Commission recognized this when it determined that price cap regulation was a much more efficient form of regulation than rate of return regulation. In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, 6790 ¶ 29 (1990) ("Price Cap Order"); Order on Reconsideration, 6 FCC Rcd. 2637 (1991) ("Price Cap Order on Reconsideration").

Clearly, no one would be clamoring for a cost of capital adjustment if interest rates had not declined since the implementation of price cap regulation on January 1, 1991.[60] If the Commission requires a one-time adjustment in LEC PCIs to reflect a change in interest rates or the cost of capital, it will undercut the foundation of price cap regulation.

Furthermore, any such adjustment would, for all intents and purposes, constitute a re-prescription of the cost of capital for price cap LECs. Neither the price cap rules nor the Part 65 Rules allow for a cost of capital prescription to reset LEC price cap rates. However, it is U S WEST's opinion that if the Commission modifies its price cap rules to allow for a cost of capital adjustment, the Commission would be required first to conduct a rate prescription proceeding "after full opportunity for hearing, upon a complaint or under an order for investigation and hearing made by the Commission on its own initiative."[61]

If the Commission determines that a cost of capital adjustment is necessary, U S WEST expressly reserves the right to make a proper evidentiary showing as to the appropriate rate of return for its interstate access services. GSA, an advocate of a cost

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[60]The question of whether LEC capital costs are less than the 11.25 percent rate that was prescribed prior to price cap implementation is a different issue. At the time, LECs found 11.25 percent to be an unreasonably low figure and presented evidence to support a higher cost of capital. USTA Reply at Attachment, Report of Dr. Randall S. Billingsley ("Billingsley Report") at Exhibit No. RSB-5 at 4.

[61]47 USC § 205(a). The Commission's Price Cap Review Notice of Proposed Rulemaking satisfies neither the statutory language of the Communications Act, the notice requirements of the Administrative Procedure Act (5 USC §§ 557, 702), nor the Commission's own Part 65 Rules (47 CFR § 65).

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Christensen Associates showed is now nearly double what our long-term total factor productivity (TFP) actually has been.

To preserve universal service and increase consumer welfare, it is also not just advisable but essential for LECs to be able to respond to competitive challenges as competitive enterprises do. We endorsed USTA's plan for segmenting markets and permitting pricing flexibility in the markets where competitive entry has already occurred and customers have choices.

I. THERE SHOULD BE NO RETREAT FROM PRICE CAP REGULATION.

Some parties openly deny that price cap regulation is good for the economy (see, e.g., Ad Hoc, pp. 6-10). Others seek a return to ROR regulation that is more thinly veiled. They argue that earnings caps and sharing (though not necessarily the LFAM) should not only continue, but should be linked to a substantially lower rate of return than under the current rules. (See, e.g., AT&T, p. 29-30; MCI, p. 29; Ad Hoc, p. 25; ARINC, pp. 3-4.) Other parties argue for more price controls. Finally, some parties argue for an increase in the productivity factor, based on earnings-derived methods that seek to assure that not only all future efficiency gains but also past efficiency gains we earned will accrue to them.

There should be no retreat from price cap regulation. The Commission cannot finesse this issue. If it changes the rules, it can only make them more like price cap regulation, or more like ROR regulation. By eliminating ROR artifacts like the backstop mechanisms from the rules, the Commission would expose us to considerably greater risk than we faced four years ago. We'd welcome this additional risk, because the alternatives are all worse.

AT&T, MCI and our other competitors want to keep our industry alive -- but only barely. The current rules under which we must operate allow them to select and exploit profitable markets without any obligation to serve the unprofitable ones. It's in their interest to keep things this way, and to constrain our financial capability to compete effectively. For example, AT&T proposes a rate true-up that, without apology, would return to its shareholders and the shareholders of other access customers all of the financial benefits of price cap regulation, leaving none for us. With the IXC price increases in 1992, 1993, and 1994 (see above, p. vi), the Commission cannot pretend that the IXCs' proposals for new price controls or rate reductions based on ROR principles would benefit consumers.

AT&T has presented the most nakedly disingenuous position of any party in this proceeding. During its own price cap rule review, AT&T presented positions both on (1) earnings and productivity under price cap regulation, and (2) the significance of market segmentation and market power in a competitive landscape, that are completely at odds with the positions it advocates in this proceeding. The Commission has a right to know what a quagmire of self-serving contradictions it

Not surprisingly, AT&T didn't recommend a cost of capital adjustment in its own price cap review proceeding, and didn't examine whether its own enterprise was more capital intensive than the economy in general. AT&T was also silent concerning any pass-through of changes in capital costs to its own price cap indices.

US West's Comments underscore another problem (US West, p. 39). An adjustment for interest rate changes may introduce a bias into production functions. With such an adjustment, LECs would have an incentive to substitute capital for labor or other inputs. LECs would be encouraged to employ fewer employees and use less noncapital inputs than they would in the absence of a cost of capital adjustment. The lesson -- which is hardly contestable -- is that singling out one input cost for special adjustment would skew decisionmaking just as it did under ROR regulation.

Finally, there's nothing unreasonable about the rates of return that have been earned by price cap LECs. They have been within (in our own case, at the lower end) of the ranges earned by companies that compete in the capital markets with us, as shown in Table 1 (above, following Summary). Indeed, they were within the range the Commission decided would be reasonable when it adopted price cap regulation.[22]

Price cap regulation and competition have increased our business risk and, accordingly, the return on equity that investors require. It's important to note that the <u>expected</u>

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[22] See Pacific, p. 36.

amount of competition, not the current amount, is what determines this expected return.[23] It's ironic -- and important to remember -- that we compete with AT&T, MCI, and Sprint for both customers and capital. That's why actions that affect their rates, and our rate of return, have serious consequences for competition as a whole.

If the Commission reduces our rates, our allowed return, or our sharing thresholds, it must also consider the strong possibility that such reductions, like the reductions in 1992 and 1993, won't benefit end users anyway. (See above, p. vii.)

C. Earnings "Manipulations"

MCI has implied (MCI, pp. 33-35) that the LECs have manipulated their sharing obligations by recording large expenses in the fourth quarter of each year. MCI's claim is implausible. We suspect that MCI doesn't comprehend the requirements of Generally Accepted Accounting Principles (GAAP), the basic financial reporting rules of the Securities and Exchange Commission (SEC), and independent auditing standards. Our suspicion is strengthened by MCI's recommendation that the LECs should publicly disclose each September all significant expenses that will be booked in the fourth quarter. Under GAAP we would be required to book these expenses in September, if issues and amounts were known and reasonably estimable at that time.

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[23] See Darby May 9, 1994 Report, pp. 8-12.

Attachment C

1. Bluefield Water Works and Improvement Co. v. Public Service Commission, 262 U.S. 679 (1923).

2. Federal Power Commission v. Hope Natural Gas, 320 U.S. 591 (1944).

3. Wisconsin v. Federal Power Commission, 373 U.S. 294 (1963).

4. Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

5. Mobil Oil Corporation v. Federal Power Commission, 417 U.S. 283 (1974).

6. Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).

7. Minnesota Association of Health Care v. Minnesota Department of Public Welfare, 742 F. 2d 442 (8th Cir. 1984), cert. denied, 469 U.S. 1215 (1985).

8. Whitney v. Heckler, 780 F. 2d 963 (11th Cir.), cert. denied, 479 U.S. 813 (1986).

9. Garelick v. Sullivan, 987 F. 2d 913 (2d Cir. 1993)